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Look at Internal Control

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A LOOK AT INTERNAL CONTROL

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It has been conservatively estimated that American business losses through fraud and employee dishonesty in the past year amounted to $500,000,000. Probably it would be a safe guess that several times this amount is lost annually through the simple process of waste and mishandling of goods. This means then, that costs running into billions of dollars a year are being incurred by American business as a direct result of some weakness in control, or perhaps even the complete lack of controls,

At a time like the present where we pride ourselves on efficiency and production it must come as quite a shock to find so much potential profit slipping right out from under our noses. However, it is actually a direct result of the growth of our economy as a whole. Perhaps, if we point out the simple parallel between the development of the machine age, as we know and accept it, and the growth of the business unit itself, we can see the reason for this.

As machines are improved the individual laborer contributes less and less to the actual construction of the product and becomes more of a machine watcher or tender. Likewise, as the business unit grows the owner, of necessity, must take a less active part in all of the activities and step back to a point where he can watch, being forced to delegate many of his functions to subordinates. The more powers he delegates the more he must resort to being a watcher or controller of others.

Only fifty years ago, an outstanding accounting scholar of the day visualized internal control as having only three essential elements, namely:

1. Division of duties
2. Use of bookkeeping proofs
3. Rotation of personnel

Today we find that most ideas as to what "internal control" encompasses are far broader in scope. The American Institute of Accountants' Committee on Auditing has given us the following definition:

"Internal Control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies."

Currently there is really nothing in the way of a business function that doesn't fall within the modern scope of internal control. Budgets are as important as the rotation of personnel; labor turnover and time study records offer possibilities for control equal to the use of bookkeeping proofs; and purchase and sales controls give advantages the same as the division of duties does.

Why is it that many successful business men today will fire an employee who slips a $10 bill out of the cash register without a moment's hesitation; and yet, admit with a wry smirk that his salesmen's expense or "swindle" sheets cost him from $25 to $50 a week more than they should, saying simply that there is nothing he can do about it? Or, what about the owner who exercises air-tight control over his cash and merchandise yet allows employees to take company trucks and automobiles home without even considering the impact that many long weekend trips will have on his profit picture? Perhaps the answer to these riddles lies in the word "education"—not from the standpoint of the three R's—but rather education as to the meaning and value of internal control in today's business picture. The last war saw many slip-shod and poorly designed business practices develop which today's fiercely competitive economy will end. What form this ending will take depends to a large extent on how well you and I do our jobs.

Why do I say that? Simply because we as accountants (public or private) are probably the best prepared individuals connected with the business organization to point up these deficiencies, whatever form they might take, and to educate employers or clients as to the benefits to be realized by eliminating them completely. The catch, however, is that too often we become so engrossed with proving our work out to a mathematical certainty that we fail to realize just what is going on around us. The old cliche is certainly applicable here and "we are often too close to the forest to see the trees."

Basically, I feel that today most businesses have a reasonably good control system in operation—at least most progressive managements are cognizant of the need for controls of some kind. Assuming that an average company does incur a loss or turn up some fraudulent activity we immediately ask then—"Why did it happen?" The answer might be one of several.

You might say the system did just what it was supposed to do.

Many times we have heard the president or some other representative of top management explode with indignant wrath when told of a fraudulent act being discovered in his company. Usually it runs like this, "What! Well I want you to completely revise the whole system and set it up so that won't happen again!"

With a bit more reflection on the subject that same executive might very well realize that his system of internal control, if responsible for the culprit being exposed, actually was adequate all the time. In fact it is very likely that it accomplished exactly what it was designed to do—that is, to reflect the unusual or the irregular act which led to the disclosure of fraud. The important point to keep in mind is that there might well be a great deal more to worry about where everything checks out perfectly each day, since the reason for such perfection could easily be an inadequate system of control which allows things to slip by unnoticed.

Your second answer as to why it happened might be to the effect that the controls are and always have been present, but the personnel in charge of carrying them out either didn't realize what they were supposed to be doing or else their work was being done in a negligent haphazard manner.

For instance, a client of ours operates a number of retail outlets throughout this area. Close checks of sales records are made by tying in closely with the regularly submitted cash register readings. In fact, we even found it worth while a few years back to insist that the register tapes accompany the reported readings. All cash must be deposited as soon as possible after the day of receipt and a duplicate deposit ticket submitted in support thereof. All disbursements are made by the main office and all bank statements are received and reconciled by the main office. On the surface everything is controlled—yet, on two occasions in the past several years we have picked up discrepancies that disclosed managers using company funds, through the simple expedient of testing deposits and the dates on which actually made. They were using the time-work plan of withholding deposits an extra day or two and using the money for their own purposes. Invariably though they became victims of their own poor bookkeeping. As the deposit would lag behind further and further it would become confused with and be made after that of a later day's sales. When this happens, there can be little doubt that manipulation is taking place.

Here an office employee was reconciling the bank accounts monthly and had even been instructed to look for just such instances. The moral is that even if the controls exist they are no better than the efficiency with which the personnel applies them. Or, if you are on the other side of the fence, perhaps the moral is that you should hire a good accountant to keep up with your defalcations.

A third, and very common-sense answer as to why a loss took place might well be that changes in procedures or lines of responsibility have been made without consideration being given to changing corresponding controls.

One company employing door-to-door salesmen required all charges for work to be calculated in the store office by the manager or the office clerk and that payments were to be made directly to the store.

One of the salesmen showed considerable enthusiasm for his job and an eagerness to do more work than was expected of him. First, he volunteered to prepare the job tickets and invoices for his work. Next, he offered to put through the charges in the office, and finally, assumed the responsibility for collection. The office clerk was only too pleased to be relieved of some of her duties. However, it will be seen that the net result was the placing of the entire accounting and collections routine in the hands of the salesman. Before long he began to charge less than the correct amounts to accounts receivable, but collected in full from the customers. The difference went into his own pocket.

Unfortunately for the salesman, one of the customers came into the office to pay his account. When it was discovered that the charge against him in the accounts receivable ledger was lower than his copy of the invoice, investigation soon revealed fraud.

The controls were sufficient in this case; they were simply not being maintained.

Another case involved a large department store where credit slips for return of merchandise required the department buyer's signature. Due to infrequent returns and the resalability of the merchandise this procedure was relaxed in a department handling household equipment in order to permit several senior sales clerks to approve these credits.

Shortly after the change small increases began to be noticed in the ratio of returned sales. When the inventory shrinkage figures began to show a slight increase also, interest was stirred enough to cause investigation.

The examination included contact with customers whose names were shown on the return slips, and it was immediately discovered that some of the names were fraudulent. The fraudulent slips were traced to one of the senior clerks. When confronted with the facts, he confessed to originating and approving completely fraudulent returns over a considerable period. Credit slips were originated by him when no merchandise was returned, and the proceeds had been collected in cash. The total amount of loss was over $50,000 due to a relaxing of controls over returned merchandise without a compensating change to offset an obvious weakness.

Many times the answer as to why a loss is suffered is simply that no appreciable measures can be taken to offset the possibility of them happening. This arises more often than not where the possibility of loss is realized but it is accepted more or less as a "calculated" risk on the part of management.

I have in mind a very recent case in which I confronted the management of a small variety store chain with the fact that one of its stores was showing a constant declining gross margin on sales. When the subject was first presented the margin had dropped from a respectable 37.5% to about 36% and management simply attributed it to a wave of shoplifting and possibly lower markups on purchases. Since the neighborhood was of questionable character that explanation seemed feasible. To make a long story short, it took a loss from operations to jar management into taking concrete action. As long as a profit was being realized no one seriously thought there was anything too wrong. Even then it took a month or more before a break developed which led to disclosure of what was happening, and that break was a clerk under-ringing a sale a mere 50 cents. A floor man caught the under-ring, took the girl back to the office and before it was over with got a substantial background of what was happening. By quick action and cooperation of a shopping service, they were able to round up twelve clerks that were involved—all confessing to stealing through the following methods:

1. Under-ringing sales, the cash being picked up by another girl from the register at an opportune time.
2. Slipping merchandise into their stockings and undergarments when behind the counter.
3. By use of accomplices that would pose as customers and receive possibly $5.00 or $6.00 worth of merchandise in a bag for only $1.00. At a later time they would get together and split the gains.

When all the smoke cleared, losses approximating $25,000 were determined—much more than the so-called "calculated risk" was expected to amount to.

Another situation that is difficult to build real controls around is the route salesman operation where promotion "deals" are made whereby the purchase of a given quantity entitles the customer to a free carton of goods. Oftentimes the salesman is tempted to keep the "free" merchandise to sell later and pocket the receipts. The best protection against this is widespread publicity and activity by sales supervisors. Usually, the supervisors will call on the larger customers and, in addition, they may ride the routes to assist the salesman at the time of the "deal."

Very often the finest system of control is rendered worthless where personal friendships and old time acquaintances are involved. For example, I read of this case some time ago:

The thief in this situation was accounts receivable clerk and since all receipts were by check he was also responsible for making deposits. This failure to establish close control over the checks as well as to separate the duties of cashier and accounts receivable clerk proved to be the weakness of the system. The checks would be stamped with the special endorsement "Pay to the order of X bank, XYZ Corporation," and this was felt to be protection against anyone shorting the receipts. However, our thief had his methods too, and when he would make a deposit a fairly large check would be presented separately to the bank teller and he would ask for cash. The explanation in this particular case was that the company needed cash for black market purchases which could not show on the books. Being well known, his explanation was accepted not only at the original bank but at a second bank when the account was changed over. In all, the fraud amounted to about $166,000, covered a period of time of over three years, involved two banks, survived several independent audits, and was only discovered when a new teller questioned the validity of the transaction.

Another case based on personal relationships involved a company operating grain elevators in small rural communities. One of its part-time managers was also a town official and well respected in his community.